IN THE UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

MARK NEWBY, Plaintiff, v. ENRON CORPORATION, ANDREW S. FASTOW, KENNETH L. LAY, and JEFFREY K. SKILLING, Defendants.	C.A. No. H-01-3624 JURY TRIAL DEMANDED
HENRY H. STEINER, Individually and on Behalf of All Others Similarly Situated, Plaintiff, v. ENRON CORP., KENNETH L. LAY, JEFFREY K. SKILLING, ANDREW S. FASTOW, and ARTHUR ANDERSEN LLP, Defendants.	C.A. No. H-01-3717 JURY TRIAL DEMANDED **ORAL ARGUMENT REQUESTED**

SECOND SUR-REPLY MEMORANDUM OF PLAINTIFFS STEINER ET AL., REITERATING THEIR REQUEST FOR ORAL ARGUMENT, WITH RESPECT TO THEIR MOTION FOR APPOINTMENT AS LEAD PLAINTIFFS FOR PURCHASERS OF ENRON PREFERRED STOCK AND APPROVAL OF THEIR SELECTION OF LEAD COUNSEL

Plaintiffs Henry H. Steiner, Christine L. Benoit, Daniel Kaminer, Michael and Jennifer Cerone, and Harold Karnes (hereinafter, the "Proposed Preferred Purchaser Lead Plaintiffs") respectfully submit this second sur-reply in further support of their motion for their appointment as Lead Plaintiffs for purchasers of Enron preferred stock and approval of their

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selection of lead counsel. We apologize for this belated submission, but the facts discussed herein just came to light yesterday in a Wall Street Journal article discussed below.

The central thesis of the lead plaintiff motion by the Proposed Preferred Purchaser Lead Plaintiffs is that there are material differences and conflicts of interest between Enron common and preferred stock which mandate the conclusion that there should be separate plaintiffs or at the least, at this juncture, separate representation for preferred stock purchasers. The representatives for each category of security purchasers (common, preferred and debt) would have actual decision-making authority for their respective groups in the event of conflicts, even if under a committee chair of one interest.

The material differences between Enron preferred and Enron common stock are graphically illustrated by the lead article in yesterday's Wall Street Journal entitled "How Treasury Lost in Battle to Quash a Dubious Security: Instrument Issued By Enron and Others Can Be Used as Both Debt and Equity." Feb. 4, 2002, at A1, col. 6. A copy of the article is attached hereto, and we urge the Court to read it in full.

The article focuses on Enron Capital LLC, one of the Enron preferred securities which is the subject of this action. Only the Steiner complaint, which was brought on behalf of purchasers of Enron preferred stock (and which was consolidated into the Newby action), specifically mentions Enron Capital LLC. Steiner Amended Complaint ¶¶24, 26 (Civil Action No. H-01-3717). Indeed, two of the movants on the lead plaintiff motion by the Proposed Preferred Purchaser Lead Plaintiffs purchased Enron Capital LLC preferred stock.

The Journal article states that Enron Capital LLC preferred stock was "invented" in 1993 and "designed in such a way that it could be called either equity or debt, as needed. For the tax man, it resembled a loan, so that interest payments could be deducted from taxable income. For shareholders and rating agencies, who look askance at overleveraged companies, it resembled equity." Id. A1, col. 6. The article's main headline calls the LLC preferred "A Dubious Security." Id. And, a diagram on the LLC Preferred is entitled "Is it debt or Isn't It?" Id. A8. Indeed, the article notes that literally scores of investment bankers, lawyers, lobbyists and government officials were involved in trying to define and explain, and in some instances hide the fine characteristics of, this financial product.

The article underscores the points made in the preferred purchasers' prior submissions on this motion. Unlike the Enron common shares, which were geared towards and purchased by large institutional investors (such as state pension funds), the Enron preferred shares were primarily marketed to retail investors. Journal article at 8 (Merrill Lynch retail marketed the Enron 1994 TOPS issue, which is Capital Trust I in paragraph 29 of the Steiner Amended Complaint). The interests of individuals who purchased "MIPS" and "TOPS" and other preferred share Enron securities largely because of the coupon or dividend payments were the opposite of the large institutional common stock purchasers who purchased their stock speculating that Enron would grow exponentially in value.

The Enron preferred securities described in the Wall Street Journal, which provided for monthly coupon-like payments, are as far removed from common stock as is possible for a preferred "equity" security (Journal passim). These preferred securities were purchased for the income payment and not for the equity participation in Enron. Steven R.

Wolfe Declaration previously filed with the Court on this motion. On the other hand, most of the preferred issues have no recourse to Enron assets, thus starkly distinguishing themselves from bonds.

The case law cited in our responsive memorandum dated January 21, 2002, clearly shows that a separate class of preferred stock purchasers should be appointed as a lead plaintiff by this Court (or at the least there should be Executive Committee representation). Weisberg v. APL Corp., 76 F.R.D. 233 (E.D.N.Y. 1977) was analyzed extensively in our responsive brief. There, the district court held that a common stockholder would not be permitted to represent holders of securities other than the common stock, stating:

> The court has ruled that Leonhardt will not be permitted to represent holders of securities other than APL common shares. It is true that in some circumstances, a trader in one type of security has been permitted to represent traders in another [citation omitted]. However, we believe that Leonhardt as a common stockholder is in no position to represent non-common stock sellers because the damages to the holders of convertible and other nonconvertible securities are much more tenuous and remote and difficult of determination so that Leonhardt would have no real incentive to delve into these complications when the determination of damages to the common stock by manipulation is so much easier. Thus Leonhardt's claims are not typical of and he cannot adequately represent sellers of non-common securities.

Id. at 238. See other cases cited in our January 21, 2002 responsive memorandum.

The case law, such as Weisberg, which supports movants' position here, does not even begin to sufficiently distinguish Enron-type preferred shares from common stock. None of the court decisions take full account of the remarkable changes in the world of finance in the last few years. None of the court decisions take into account Enron's deliberate attempt, through the aggressive financial engineering implemented by Enron in the last few years, to play both sides of the line separating debt from equity securities. The profile of the Enron preferred securities is

substantially dissimilar from the profile of common stock. Wolfe Decl. passim. Accordingly, purchasers of Enron preferred stock relied upon different misrepresentations in Enron's public filings and statements. Moreover, the inherent nature of the preferred shares kept their share price afloat much longer than the common stock after the curative disclosures began. Thus, a different method of proving liability and calculating damages is required for the preferred share purchasers than for common share purchasers. Wolfe Decl. passim. Indeed, as the Weisberg Court stated, if the common share purchasers were to be in charge of this litigation on behalf of the preferred stock purchasers, the common stock purchaser representatives "would have no real incentive to delve into these complications." In fact, for whatever complications were foreseen in the Weisberg ruling, the financial structuring of "MIPS" and "TOPS" (and the other Enron preferred securities) raise the "complications" foreseen by Weisberg to a new level.

We submit that the Journal's extensive analysis confirms that given the features of Enron preferred securities, they are neither fish nor fowl, but are a completely separate kind of animal, and must be treated separately from both Enron common stock and Enron debt – with separate lead plaintiffs and lead counsel, or at the least separate representation.

Dated: February 5, 2002.

Jack E. McGehee, TBN 13623700, Fed No. 8163
OF COUNSEL:
McGehee & Pianelli, L.L.P.
James V. Pianelli TBN 15966740, Fed No. 11557
1225 N. Loop West, Suite 810
Houston, Texas 77008
(713) 864-4000
(713) 868-9393 fax
TEXLAW@LAWTX.COM

WOLF HALDENSTEIN ADLER FREEMAN & HERZ LLP
Daniel W. Krasner
Jeffrey G. Smith
270 Madison Avenue
New York, New York 10016
(212) 545-4600
(212) 545-4653 fax
www.whafh.com

Attorneys for The Proposed Preferred Purchaser Lead Plaintiffs 258639

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing Second Sur-Reply Memorandum Of Plaintiffs Steiner Et Al., Reiterating Their Request For Oral Argument, With Respect To Their Motion For Appointment As Lead Plaintiffs For Purchasers Of Enron Preferred Stock And Approval Of Their Selection Of Lead Counsel has been delivered by serving all counel of record on this the _____ day of February, 2002.

JACK E. MCGEHEE

A1, col. 6

THE WALL STREET JOURNAL MONDAY, FEBRUARY 4, 2002

Double Play

How Treasury Lost In Battle to Quash A Dubious Security

Instrument Issued by Enron And Others Can Be Used As Both Debt and Equity

Win for Flotilla of Lobbyists

By JOHN D. MCKINNON
And GREG HITT
Staff Reporters of THE WALL STREET JOURNAL

In 1993, Goldman Sachs & Co. invented a security that offered Enron Corp. and other companies an irresistible combination.

It was designed in such a way that it could be called debt or equity, as needed. For the tax man, it resembled a loan, so that interest payments could be deducted from taxable income. For shareholders and rating agencies, who look askance at overleveraged companies, it resembled equity.

To top officials at the Clinton Treasury Department, the so-called Monthly Income Preferred Shares, or MIPS, looked like a charade—a way for companies to mask the size of their debt while cutting their federal tax bill.

Moves and Countermoves

- **Treasury's O'Neill favors strong steps to hold corporate chiefs accountable, A2.**
- **A report by Enron's board finds improper financial transactions, A3.**
- **Andersen retains Volcker to spearhead changes in its business practices, A3.**
- **Lay backs out of a scheduled appearance to testify on Capitol Hill, A8.**
- **Several companies may follow Disney's move to curb auditors' multiple roles, A6.**

Treasury made repeated attempts to curtail their use. In 1994, it scolded Wall Street firms and asked the Securities and Exchange Commission to intervene. The next year, the department sent legislative proposals to Congress aimed at closing loopholes and punishing offenders. In 1998, the Internal Revenue Service tried to disallow Enron's tax deductions. Each move was beaten back by a coalition of investment banks, law firms and corporate borrowers, all of whom had a financial stake in the double-edged accounting maneuver.

The MIPS saga shows how moneyed interests, with armies of well-connected lobbyists and wads of campaign contributions to both parties, defeated the Treasury's efforts to force straightforward corporate accounting. With corporate bookkeeping now under scrutiny, the story of this flexible financial instrument shows how such accounting gimmickry gained acceptance.

Enron's collapse cannot be traced to any one decision. But the survival of MIPS was an early milestone for what became a series of transactions in which the company borrowed more and more without making clear that was what it was doing.

In the first of several similar deals, Enron in November 1993 set up a subsidiary called Enron Capital LLC in Turks and Caicos, a Caribbean tax haven. The unit sold about $214 million in preferred shares—the MIPS—to investors through Goldman Sachs, promising an 8% annual dividend paid in monthly installments. The subsidiary then lent the proceeds to the parent corporation, to be paid back over 50 years or more,

Two Treatments

Enron deducted from its taxable earnings about $24 million in interest payments that it paid in 1993 and 1994 to Enron Capital, according to IRS court filings. But in reports to shareholders, Enron described the obligation as "preferred stock in subsidiary companies."

Even though Enron had in effect gone $200 million in debt, company executives figured its credit rating would actually improve. Lea Fastow, then working in corporate finance at Enron (and the wife of Andrew Fastow, later Enron's chief financial officer) told Institutional Investor magazine in October 1994 that the MIPS offerings were part of an effort to raise its rating from triple-B to single-A by the end of 1995. By December 1995, Enron's credit rating was up to triple-B-plus.

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MIPS transactions would, she said, reduce the company's debt-to-equity ratio. But Standard & Poor's, in its rating of November 1993 of the first MIPS deal, cautioned that Enron's financial maneuvers were "aggressive and not particularly supportive of credit quality." A spokesman for Ms. Fastow said she declined to comment.

From Seedling to Forest

The details of MIPS were disclosed in SEC filings, which came to the Treasury's attention almost immediately. Treasury officials feared this seedling would sprout into a forest, and they were right. Enron, one of two MIPS pioneers—the other was Texaco—eventually issued at least $1 billion of MIPS and similar securities, known generically as "trust preferred" securities. Texaco, now part of ChevronTexaco Corp., issued at least $525 million. Utilities, banks and other companies found them attractive, too. In all, $180 billion of trust-preferred securities is outstanding.

After reviewing the documents on Enron's 1993 transactions, Treasury tax officials—led by Leslie Samuels, then the assistant secretary for tax policy—moved quickly, hoping to act before too many other corporations and individual investors become involved in MIPS-like deals. Early in 1994, Treasury and IRS officials summoned investment bankers and lawyers to express Washington's skepticism about the deals.

To put extra pressure on Wall Street,

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the Treasury officials invited SEC staff to sit in on the meeting. The goal was to keep the investment bankers from telling two different stories to the two sets of regulators: telling the IRS that the problem was with how MIPS are handled in SEC filings, and telling the SEC that it was a tax issue.

The Wall Street bankers and lawyers weren't persuaded. So the Treasury beseeched SEC staff to stop the practice. "One of the pitches the Treasury made was, 'Do you realize that companies have billions of dollars of debt that isn't showing up as debt?' " according to an official who was there. The SEC did little except recommend that companies change the way they describe the securities. The SEC suggested describing them as "company-obligated mandatorily redeemable security of subsidiary holding solely parent debentures" or similar wording.

An SEC spokesman declined to elaborate on guidance the agency issued that says companies should "consider the adequacy of disclosures" about trust-preferred securities and "describe fully the terms" in footnotes.

Later in 1994, the IRS issued a formal statement, warning companies that it would be scrutinizing MIPS and similar securities, and would consider rejecting interest deductions if they were for securities treated as equity in corporate financial statements to shareholders.

All this had little effect, though. Merrill Lynch, with its substantial base of retail investors, joined the party with a $75 million Enron issue in 1994, dubbing its version Trust-Originated Preferred Securities. Other companies did the same.

So in late 1995, looking for ways to raise tax payments by corporations to reduce the federal budget deficit, the Treasury assembled a list of corporate tax and accounting abuses to target, and put MIPS near the top of the list.

Redrawing the Line

In an unusual move, the Treasury unveiled its legislative proposals on Dec. 7, 1995, criticizing "blurring of the traditional line between debt and equity." The Treasury's tax proposals typically are a little-noticed sidelight in the president's budget when it comes out in early February.

"We knew Wall Street was working furiously to exploit tax loopholes with financial instruments, and the industry correctly perceived that we were targeting that activity," said Clarissa Potter, an ex-Treasury official now at Georgetown University Law Center.

Businesses account for all sorts of transactions one way on their tax returns and another way in shareholder accounts. Companies often depreciate investments more rapidly on their tax returns—which means bigger depreciation charges that reduce profits subject to federal taxes—than they do in the profit reports they give shareholders.

But MIPS and their kin were particularly aggressive. And the Treasury's proposals to quash them were tough. They would have denied the interest deduction for any transaction lasting more than 20 years that was not treated as debt for accounting purposes. They would have punished not only the parent company but other businesses that got involved in the deals, denying them another deduction that is available to corporations. The Treasury also said its restrictions should be effective as of Dec. 7, no matter when Congress acted. The Treasury estimated that its proposals would raise $800 million in additional revenues over five years.

Wall Street reacted forcefully. "Dec. 7, 1995, is a day that will live in infamy," Micah Green, head of the Bond Market Association, a trade group, said publicly at the time, condemning the Clinton proposals.

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The backers of MIPS and other trust-preferred securities assembled a flotilla of well-connected lobbyists to fight the Treasury. Among them: Mark Weinberger, who is now the Treasury's top tax official; Nick Calio, who was a lobbyist for the first Bush White House and is now chief lobbyist in the second; Fred Goldberg, who was the top tax official and IRS commissioner in the first Bush administration; Kenneth Duberstein, who had been Ronald Reagan's chief of staff; and Lawrence F. O'Brien III, who had been a lobbyist in the Carter Treasury.

A law firm that did significant work for Enron, Vinson & Elkins, registered as a lobbyist for both Enron and Goldman Sachs. Enron itself reported lobbying expenses—not counting campaign contributions—of $530,000 for 1996 and $1 million in 1997 on "budget and tax legislation" including "corporate welfare."

Their first goal was to get rid of the Dec. 7, 1995, effective date. Victory came in March 1996 when the chairmen of the tax-writing committees, both Republicans, said that even if they adopted some Clinton proposals, they wouldn't make them "retroactive."

But the Treasury continued to press its proposal to treat as equity, and therefore ineligible for any interest tax deduction, any financial instrument that had a term of more than 20 years and wasn't shown as debt on the company's balance sheet.

The lobbyists successfully asked members of the House and Senate tax-writing committees to announce their opposition to the Treasury proposals in letters to colleagues or to the Clinton administration.

Those letters, in turn, became fodder for lobbyists seeking broader support. The Bond Market Association would eventually assemble an inch-thick collection of critical letters—some from lawmakers and some to them from financial-market critics of the proposals. "It's the heft of the thing, the thud when it hits the table," says John Vogt, the bond industry's top Washington lobbyist, who still keeps a copy.

One letter, signed by Jon Corzine, then chief executive officer of Goldman Sachs, and 34 others portrays the Treasury as attempting to draw "completely arbitrary" lines between debt and equity. Mr. Corzine, now a Democratic senator from New Jersey, says it's unfair to equate Enron's early use of the new financial instrument, which was disclosed in SEC filings, with its subsequent creation of partnerships to hide debt and generate dubious earnings.

'A Legitimate Question'

"I'm not saying it wasn't aggressive tax policy—that's why the Clinton administration did what it did—but it wasn't designed to hide bad assets," Sen. Corzine says. "There was a legitimate question with regard to the tax treatment," he said. But "lawyers said it was right. Accountants said it was right—not that that counts for much now—and the courts said it was right."

As the battle intensified, the U.S. Chamber of Commerce and the National Association of Manufacturers joined the fray. Merrill Lynch, in written testimony to Congress, said there wasn't any need to worry because trust-preferred securities "are issued by well-established companies that are likely to remain in business throughout the term of the obligation."

Wall Street argued that everyone except the Clinton administration was now comfortable with the securities and that the administration was simply trying to raise business taxes. "The target may be Wall Street but the victims live on Main Street.... It is going to come out of people's pockets, and the people who are paying are largely going to be workers and middle-class savers," testified Mr. Goldberg, the former IRS commissioner then at the law firm of Skadden Arps, which had helped structure some of Enron's trust-preferred deals. Mr. Goldberg said at the time that he wasn't lobbying on behalf of any specific client, though he acknowledged that several were interested. He declines to comment now.

In the end, only a few Clinton corporate-tax proposals became law in the summer of 1997. The proposals aimed at MIPS and other trust-preferred securities were largely forgotten—until Enron's collapse.

But the IRS didn't give up. In an audit of Enron's tax returns, IRS field agents in Texas challenged Enron's deductions for its MIPS-related debt. The argument was simple: the securities were more like equity than debt, and dividends on equity aren't tax-deductible.

Enron appealed the IRS action to the U.S. Tax Court in April 1998. The Wall Street lobbying forces swung into action again, unhappy that the IRS action was making it difficult to do new trust-preferred securities. In the summer of 1998, lawyers for the Wall Street Tax Association—an organization of tax professionals in the securities industry—came to IRS headquarters in Washington to complain that the challenge was legally flawed and unfair to the now well-established markets in the securities.

"It would be a great pity if we all collectively are forced to wait years for a Tax Court decision in Enron to establish what should be a straightforward proposition," Ed Kleinbard, a lawyer who worked with the association, wrote at the time in Tax Notes, a newsletter.

On Christmas Eve 1998, the IRS quietly folded, telling the Tax Court that the deal was legitimate—for tax purposes. "Enron Capital is a valid entity that is separate and distinct from Enron for federal income tax purposes," the IRS conceded. That meant that "the 1993 loan constitutes indebtedness of Enron for federal income tax purposes."

Mr. Weinberger, the lobbyist-turned-Treasury official, says the IRS decision to back away proves that the industry position was correct: "We said this is a legitimate financing tool for corporations."

A spokeswoman for Goldman Sachs, Kathleen Baum, makes a similar point: "Trust-preferred securities have become a standard component of corporate finance issued by hundreds of companies across industries. There is full disclosure in financial statements, and they are well understood by the rating agencies." Defenders of trust-preferred securities say rating agencies only give them some credit as equity. But critics say they should be reported more clearly as debt.

Getting Around the Rules

Lynn Turner, the SEC's chief accountant from 1998 to 2001, said trust-preferred securities are an example of the aggressive accounting that grew in frequency during the 1990s while regulators dawdled. "As a result, we have balance sheets getting much better credit ratings than they should, and companies looking more liquid and in much better financial shape than they are," he said. "This is a very good example of how the professional community, including underwriters, attorneys and auditors, was trying to find ways to structure things to get around the rules."

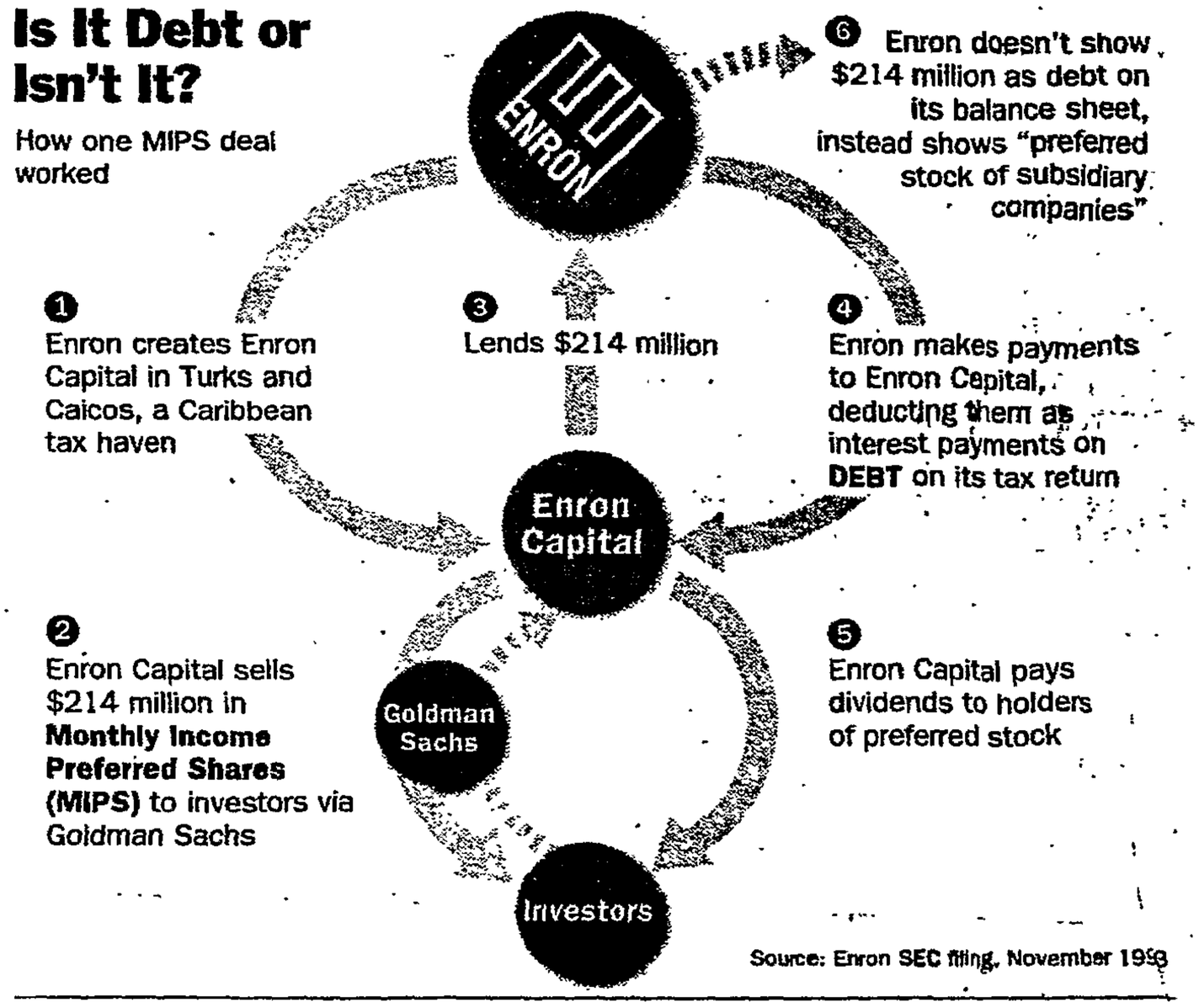
Since Enron's implosion, the Financial Accounting Standards Board, which sets accounting standards, has revived efforts to resolve the controversy over securities that purport to be debt for some purposes and equity for others. The Treasury's deputy assistant secretary for tax policy, Pam Olson, told a New York tax-lawyers group recently that there's new reason to think about closing the gap between financial accounting and tax accounting. But Treasury officials emphasize that they aren't among the agencies investigating Enron's finances and haven't come to any conclusions about the role debt-equity arrangements played in its collapse.

On Jan. 24, the senior Democrat on the House tax-writing committee, Charles Rangel of New York, introduced legislation similar to the Clinton Treasury's failed proposals. It would penalize companies unless they disclose any debts as liabilities, even debts of off-balance-sheet partnerships. "If Congressional Republicans had permitted action on that [Clinton] proposal, we might not have seen the spectacular rise and collapse of Enron," he says.

To which Mr. Vogt, the bond-market lobbyist, replies: "Clinton dropped the proposals from his budget. Now that similar proposals have resurfaced, we're on our way back to the Hill."

Is It Debt or Isn't It?

How one MIPS deal worked



Source: Enron SEC filing, November 1999